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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF EPCOR WATER ARIZONA INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT, PARADISE VALLEY WATER DISTRICT, SUN CITY WATER DISTRICT, TUBAC WATER DISTRICT, AND MOHAVE WASTEWATER DISTRICT.N THE MATTER OF

Docket No. WS-01303A-14-0010

Arizona Corporation Commission
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RUCO'S REPLY BRIEF

The Residential Utility Consumer Office ("RUCO") hereby files its Reply Brief in this matter. RUCO's Closing Brief was long and covered the disputed issues in question at length. It is neither the intent nor the desire of RUCO to restate its case in this Reply. Rather, RUCO will only reply to arguments not addressed in its Closing Brief or to supplement any points made already – so to the extent RUCO does not respond in this Reply Brief to any argument made, RUCO refers the Commission to its Closing Brief on the subject which in essence is also RUCO's reply to the arguments raised by the Company and the other intervenors.

1) ACCUMULATED DEPRECIATION

With regard to the utility plant in service ("UPIS") accounts that are over-depreciated with excess credit accumulated depreciation ("A/D") balances – R-1, the Company argues that there is no evidence the Company applied incorrect depreciation rates and that the Company did not earn its authorized rate of return. Company Brief at 13.

The Company's arguments regarding the over-depreciated accounts are not persuasive. In what universe is it ever appropriate for ratepayers to pay for an asset more than once? The obvious answer to that is it is never appropriate. The discussion should then move to how the Commission makes the past over-collections right for the ratepayer and putting an end to future collection on all of these more than fully depreciated UPIS accounts. The fact that the Company used correct depreciation rates and did not earn its authorized return does not make it right – those arguments are red herrings and irrelevant. There is also no NARUC or other regulatory accounting which supports the Company's position that it is appropriate for the Company to collect from its customers multiple times over "of" the same plant as well as a return "on" it. In fact, as set forth in RUCO's Closing Brief, the Commission Rules, A.A.C. R-2-102(A)(3) prohibits it. See RUCO Brief at 13. The Company's arguments here are nonsense and should be rejected. The Commission should put an immediate end to the continued collection of depreciation expense on all of these accounts and credit ratepayers for past over-collections. There is clear indications in the record that most of these accounts were over-depreciated in the districts' previous rate cases. Transcript at 422-427.

With regard to the debit A/D balances – R-3, the Company complains that both RUCO and Staff seek to undo the majority of the debit A/D balances without support. Company Brief at 4. The Company further claims that RUCO and Staff's approach could be viewed as retroactive ratemaking. Id.

RUCO agrees with the Company's statement that RUCO is seeking to undo the majority of the debit A/D balances. RUCO disagrees that its position is unsupported. Likewise, RUCO disagrees that its approach "could" be viewed as retroactive ratemaking.

The Company posits several reasons for its position – all of which are easily dismissed. The Company mentions that it purchased these systems from American Water and the authorized rate base for each district was included in the determination of the purchase price. Company Brief at 4. The suggestion here is that the previous balances were already approved and the Commission is bound by its previous decision. Coupled with this argument is the Commission's traditional approach to debit A/D. Company Brief at 5. According to the Company, when the original plant being retired is more than the accumulated depreciation recorded in the account, the result is a debit balance which the Commission traditionally approves and the result is an increase to rate base. Company Brief at 5.

There clearly is a problem with the number of debit A/D balances and the number of over depreciated accounts. Debit A/D balances are not normal and the number and amounts of the debit balances and the over-depreciated accounts in this case is far from normal. R-15 at 11. The accumulated depreciation balances raise an immediate red flag and should have done the same when the Company purchased the water system from its predecessor American Water. To argue that the Commission approved A/D balances in the past and is now bound by its previous decisions when there were clearly mistakes made, is tantamount to saying that it is okay for the Company to stick its head in the sand and not engage in due diligence when it acquires another entity because whatever accounting errors or inappropriate accounting that has taken place in the past has been validated by the Commission in a previous Decision and is not subject to change. This argument is nonsense. The Commission's hands are not bound and it has the authority to correct mistakes when they become known. The Company has not provided any authority, legal or otherwise which limits the Commission's authority to correct prior mistakes or inappropriate accounting.

Again, it is worth pointing out that the Company goes to great length to explain the process that it believes a party must go through to modify a previous decision. Company Brief at 8 – 11. The irony is not lost that Company disregards the same legal process that it so strongly believes is necessary when it comes to the Company's approach to the CAP costs in rate base. RUCO Brief at 30-31. There, however, the Commission's prior Decision still makes sense to follow. Here, there is a compelling need to modify mistakes, errors and other oversights that became apparent in this rate case. Even the Company agrees that the Commission has broad authority to modify and amend its prior decisions. Company Brief at 9. The facts in this case could not be more compelling to address the mistakes of the past.

RUCO does not argue that the Commission cannot nor should engage in retroactive ratemaking to address the debit balances and the over-collected A/D accounts. But neither RUCO nor Staff is suggesting that retroactive ratemaking is the solution. Neither RUCO nor Staff is recommending that the Commission address the A/D balances in a way that changes the rate and then apply that rate retroactively. The Company has not shown that either the Company or Staff are recommending that – because neither RUCO nor Staff are making that recommendation. The Commission can surely address any prior mistakes/discrepancies in the A/D balances by providing a credit to the customers moving forward. One thing that is for sure is that simply ignoring the A/D accounts is not the solution - ratepayers deserve better.

Perhaps even less persuasive is the argument that RUCO has not provided support for its position. RUCO would argue that the Company is the one who is short on support. RUCO does acknowledge that many of the abnormal debit A/D balances were the result of early retirements. R-15 at 9. According to Mr. Coley, there were three reasons that led to the abnormal debit A/D balances;

1. Early retirements caused most of Mohave Wastewater District's debit A/D balances, which will be discussed in more detail later;
2. Improper accounting when retiring a group of assets from non-depreciable accounts; and
3. Improper accounting when making transfers of assets from one account to another.

R-15 at 9.

RUCO would agree that debit A/D balances are plausible whenever large retirements are made early in an asset's average serviceable life. R-15 at 10. But the evidence in this case shows that the retirements were anything but normal. For instance, it is odd to have an entire district's A/D balance result in an abnormal debit balance as happened in the Mohave Wastewater District. Id. Mr. Coley, RUCO's witness, breaks down in his testimony just how unusual the Mohave Wastewater retirements are in this case. Had the Company filed a rate Application for the Mohave Wastewater District using a test-year ending December 31, 2008, the Company's first two-lines on Schedule B-1 would have reflected the following:

Gross Utility Plant in Service	$6,821,733
Less:	
Accumulated Depreciation	($ 20,461)
Net Utility Plant in Service	$6,842,194

Id. The utility industry, particularly the water and wastewater industry,[1] requires significant investment to generate a dollar of revenue. Therefore, depreciation expense is one of if not the largest expense found on the income statement of utilities due to the capital-intensive nature of the water utility industry. In the scenario provided above, the district's overall accumulated depreciation balance has a debit or abnormal balance. Id. In September 2010, 21-months later, retirements again resulted in a near overall debit A/D balance. Id. In other words, the Company is carrying a debit accumulated depreciation balance. Id. Rather than the normal reduction to the utility plant in service ("UPIS"), the abnormal debit balance in A/D in this case is an addition to UPIS. It raises questions as to "how" and "why" this A/D balance resulted in an overall abnormal debit balance. Id. When asked how this is possible, here and in other cases throughout, the Company's response was generally either it was due to early retirements or it was approved in the last rate case. Id.

Another very unusual, as well as unexplained, phenomena regarding the "retirements" in the Mohave Wastewater District is the number of significant retirements that have been made over an approximate twelve-year time span. Id. The number of early retirements begs the question of whether the Company properly plans and constructs plant in a manner that cost effectively meets the needs of its ratepayers. Id. Why should the ratepayer be obligated to provide recovery of an investment repeatedly being replaced due to improper planning on the Company's behalf? Id.

In the Mohave Wastewater District, assets totaling $352,213 were retired early due to water / storm flood damage. R-15, Attachment 4 at page 3. This total increased the overall total debit A/D balance ($352,213) which of course increased the rate base. Why didn't the

[1] The water and wastewater industry requires the most capital investment than any other utility industry to generate $1 of revenue. Id.

Company, a water/wastewater Company have insurance to cover this event? If it did have insurance, why is it that this balance is a debit A/D balance which has the effect of increasing customer rates – i.e., why should the customer have to pay for the assets lost that the Company collected on through insurance or assets lost that were not insured when they should have been insured? This should be a Company problem – not the customer's problem.

This discussion on retirements is made to put some true perspective on the Company's claim that early retirements are not abnormal and the Commission traditionally approves the debit balance – which in this case amounts to ($3,170,346). There is nothing normal about that amount, and nobody argues these large balances are incorrect.

There are numerous instances where the debited A/D balances are simply the result of error. These errors, however, are made at the expense of the customer, and enrich the Company. Again for illustrative purposes, in 2006 the Company transferred $2,981,428 of assets from one account to others and debited the depreciation balance for the same amount for $2,981,428. R-15 at 13, Attachment 5. This is improper accounting for a transfer of assets. Moreover, this account has a zero depreciation rate. Thus, there is no depreciation accounted for on these assets and no A/D to transfer. Id. The Company's accounting treats the asset transfer as if it were a retirement which is improper by any accounting standard – NARUC, Commission Rules, etc. Id.

The heavily covered "Organization Account" in the Paradise Valley District is another example – Account # 301000. R-3. This account is detailed in Mr. Coley's Surrebuttal Attachment 5 in the first account titled "Organization." The attachment shows a non-depreciable Organization account with a zero depreciation rate with a plant value of $15,350 but with a debit A/D balance of $477,338 in year 2004. R-15, Attachment 5. As a starter, this account is also non-depreciable and should not have any depreciation associated with it. Id.

Yet, it reflects a $477,338 debit A/D balance as of 12/31/2007. Id. The Company has created a $492,688 phantom asset from a plant balance with only a $15,350 balance as of 12/10/2004. Id. RUCO has supported its case throughout – the Company cannot explain this balance other than to say it is some unexplained accounting discrepancy between the accounting ledger and the fixed accounting system's accumulated depreciation balance. Transcript at 109, 152, 1132, and 1142. Meanwhile, RUCO has looked at this error and determined that it is costing ratepayers $590,288 over a ten year period. R-3. It is the Company, not RUCO that cannot support its case, and it is a shame that the Company is not offering some remedy for the ratepayer.

The Company's arguments should be rejected and the Commission should adopt RUCO's recommendations.

2) **POST-TEST YEAR PLANT**

As RUCO stated in its direct testimony, it was necessary to hire an engineering expert in this case, due to the engineering approach of Staff in the Chaparral City Water Case. R-9 at 2. Typically, RUCO will rely on Staff's engineering report when it comes to an engineering analysis of post-test year plant in a water rate case. RUCO believes that it is unnecessary for the state to pay twice for an analysis of something as basic as post-test year plant. In the Chaparral City Water case, however, Staff's engineer claimed that all the post-test year plant was buried and did not bother to look at it.[2] Unfortunately, it seems the same thing has happened again in this case – at least prior to the hearing.

Staff has further agreed with the Company in this case on the issue of what is to be included and created a new policy of dividing Post-Test Year Plant into Investment Projects

("IPs") which are described as non-routine projects that have a defined life and require funding greater than $100,000, and now ***a new category*** called Post-Test Year Recurring Projects ("RPs") which are routine in nature and less than $100,000.[3] The Commission and the parties are all familiar with IPs, as all water companies seek recovery of IPs in their rate case filings. What is new, is Staff has agreed with the Company and has now allowed RPs in post-test year plant which is different from the way Staff suggested and the Commission approved in the Company's last rate case for these systems. See Decision No. 71410. Even the Company's witness, Mr. Troy Day, acknowledges that the attempt here is to put in just about every type of post-test year plant:

> "So what we are trying to do is capture all the costs that we possibly can. And the post-test year plant additions allow a company to have a shot at earning their authorized ROE. Without post-test year plant, there is just really no chance of a water company even being able to get close to the authorized ROE."

Transcript 260.

Similar to the Chaparral City Water case, a big problem in this case is Staff's engineer, Mr. Michael Thompson, made no used and useful determination on these RPs - until *after the hearing*. To Staff's credit, in an effort to correct this deficiency, Staff submitted supplemental post-hearing testimony on April 8, 2015. The supplemental Staff report indicates that the Company claimed it had completed 127 RPs, but Staff had only verified 23 RPs or approximately 18 percent of the total RPs. See Supplemental Testimony of Michael S. Thompson, Supplemental Engineering Report at pages 2-11, dated April 8, 2015. In fact, Staff's engineer never made a *used and useful* determination for these RPs in the Tubac Water District. See Supplemental Testimony of Michael S. Thompson, dated April 8, 2015.

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[2] See RUCO closing brief, page 4 in Docket No. W-02113A-13-0118.
[3] See Staff closing brief, page 10 in this case.

3) <u>UNEXPENDED CIAC</u>

The Company admits that when it collects CIAC from developers it does not use separate bank accounts to deposit the cash. Transcript at 117. There is no tracking of these funds once they are deposited to ensure that the funds are matched with the appropriate capital project(s). Transcript at 117. It is also not earning any interest. Id. In fact, the money can be used to pay operating expenses, such as salaries/wages, purchased power, and chemicals or these funds could be sent directly to the Company's parent company as dividends. The bottom line is the Company has received this cost free source of capital, i.e., cash/money from developers and has made the funds available for its test year operating expenses. This is a gross mismatch and hence inconsistent with the matching principle.

Staff condones this treatment. If the Commission is inclined to allow this, then it should at least require the CIAC to be tracked in a separate interest bearing account and the interest earned treated as other revenue. Further, if the Commission allows this treatment, the Commission should order the Company to immediately place these funds into an interest bearing bank account; and provide as a compliance item in this docket a bank statement within 30 days of a decision in this matter. Further, RUCO recommends that any interest earned on the money be recorded above the line in other operating revenues.

4) <u>ADDITIONAL STORAGE IN TUBAC</u>

James Patterson and Richard Bohman on behalf of the Santa Cruz Valley Citizens Council refer in their Closing Brief to an engineering Staff report done by Staff engineer Mrs. Dorothy Hains which was submitted on June 1, 2009. See Closing Brief of Patterson and Bohman at page 6. Mrs. Hains' report seems to be at odds with what Staff's engineer Michael Thompson has recommended in the current case. The Company has also not taken a hard stance on whether 100,000 gallons of additional storage is needed in Tubac, and, in fact, the Company believes that an engineering assessment should first be done. Closing Brief of Company at 41. RUCO agrees with the Company and the intervenors on this point. However, RUCO does not support leaving the case open, as was recommended by Staff, to allow for future plant if it is later determined to be needed.

5) PHASE-IN OF RATES IN TUBAC

RUCO is not opposed to the phase-in of rates of Tubac, as the Tubac intervenors have recommended, as long as there are no carrying charges associated with the phase-in.

6) SYSTEM IMPROVEMENT SURCHARGE ("SIB")

The Company has provided no evidence that a SIB recovery mechanism is necessary in the Mohave, Sun City and Paradise Valley Water Districts. RUCO has presented its objections to a SIB mechanism in prior case applications and has also documented these prior objections in this case as well.[4] In addition, EWAZ should not be awarded a SIB mechanism as the Company is submitting approximately 80 percent of its earnings, $23,962,545[5] to its parent in the form of dividend distributions. This compares to 55 percent that publicly traded water utility companies are paying their shareholders in the form of dividend payments. Id. Is this fair to Arizona ratepayers - hardly! Should EWAZ retain a larger portion of its earnings for infrastructure improvements - absolutely! A principle source of funds for infrastructure improvements is provided by earnings retained in the business. EPCOR's actions make it clear that maintaining its infrastructure is not a priority and that a SIB is not warranted.[6]

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[4] RUCO's Closing Brief, pages 56 - 66
[5] R-21 at 22-24
[6] R-18, Attachment 3

Accordingly, to award the Company a SIB here provides incentive for the Company to continue to pay dividends to its parents at the expense of "needed" infrastructure. This is exactly the "perverse" incentive that the SIB should not provide a utility.

In its Closing Brief, Staff states "Under the proposed SIB mechanism, the projects will be subject to a usefulness and prudency review in the Company's next rate case, and any approved surcharges will be subject to true-up and refund."[7] If all SIB projects are approved by the Staff, as EPCOR has requested, the rate base for these three systems will be increased by $28,246,638 without a determination of usefulness and whether the projects were prudent. This represents an increase in the rate base of the Mohave System of 43 percent, Sun City of 41 percent and an increase in the Paradise Valley rate base of 17 percent.[8] Ratepayers will be paying an additional $2,833,281,[9] in rates by the end of year five representing an additional 80 percent increase in revenues over and above the revenue increase requested by the Company in its final rate schedules filed with the Commission in this rate case. These are extremely large increases in revenues that will be awarded to EPCOR without the benefit of a full rate case filing and in particular a determination of usefulness. This is not fair to the ratepayers in these respective districts and the SIB mechanism should not be approved for these three systems.

RUCO also has no reason to believe that any of these projects that have been requested through a SIB mechanism will be inspected and a used and useful determination made by Staff when the next rate case is conducted. As explained above, Staff's engineer had inspected and only made a used and useful determination on $5.6 million of the Company's requested post-test year plant of $12.2 million prior to the hearing and only a very limited

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[7] Staff's Closing Brief, page 20
[8] RUCO's Closing Brief, page 52

review after the hearing. Testimony at 730, Supplemental Staff Testimony of Mr. Thomson filed on April 8, 2015. Why should RUCO presume that Staff will treat the SIB plant review any different?

7) <u>COST OF CAPITAL</u>

RUCO continues to recommend a Cost of Common Equity of 8.91 percent and a Cost of Debt of 4.60 percent. R-21 at 3. RUCO is recommending an overall cost of capital of 6.09 percent. Id. RUCO basically agrees with the Company's calculated cost of debt but differs significantly in its calculation of cost of equity. RUCO prepared three separate models in calculating its cost of equity analysis as did the Company, however, the Company included a Predictive Risk Premium ("PRPM™") and was given three times the greater weight based on a "minimum of restrictive assumptions." It should be pointed out that the PRPM™ was not accepted by the Commission in the recent Chaparral City Water Company's rate case, and when asked if this model had been accepted by any other regulatory agency, Ms. Ahern's response was "obliquely." Transcript at 618. In other words the PRPM™ has not been accepted by any regulatory agency.

RUCO's cost of equity, 8.91 percent, is consistent with Staff's cost of equity calculation of 8.90 percent, but Staff then added an additional 60 basis points on its results for what is referred to as an economic adjustor. There is no tangible support for the 60 basis points which Staff's witness basically admits. When questioned by ALJ Nodes how the 60 basis points was derived, Staff responded "I believe it was to give recognition both to the domestic as well as the international economy, the broader global view, I suppose. It was, that was my understanding at least." Transcript at 661. Staff's witness was also asked by ALJ Nodes,

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[9] RUCO's Closing Brief, pages 52, 53

"without respect to the individual company but just in general for all utility companies until further notice, there is an adder of 60 basis points to reflect uncertainty in the domestic and worldwide economy?" Staff answer was "Yes." Id. There will always be uncertainty in the worldwide economy – so is Staff suggesting the Commission should always approve a 60 point adder? There is no support for the 60 basis points that Staff included in its analysis and should be disregarded.

The Company's final cost of equity calculation, before any adjustments is 9.72 percent.[10] Once that calculation was made Ms. Ahern then added 24 basis points as a credit risk adjustment and 30 basis points for a business risk adjustment. Id. Not only did Ms. Ahern add her own adjustments of 54 basis points she then added one-half of the Staff's economic adjustor, 30 basis points, for total adjustments of 84 basis points. Id. There is no basis for either the credit or business risk adjustments.[11] EPCOR is paying approximately 80 percent of its earnings as dividends to its parent compared to approximately 55 percent being paid in dividends of the proxy group of companies used for analytical purposes. EPCOR Utilities has an A credit rating with DBRS and was recently upgraded to an A- rating by S&P. EWAZ's cost of long-term debt is 4.30, a very favorable interest rate compared to APS (Four Corners transaction) and UNS (Gila River purchase). Id. The Company does not warrant any adjustments for business or credit risk and as stated above there is no justification or support for Staff's economic adjustor. The Commission should approve a cost of capital of 6.09 percent as RUCO recommends based on the facts in this case.

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[10] EPCOR'S Post Hearing Closing Brief, page 20

[11] RUCO's Closing Brief, pages 49, 50

8) CONCLUSION

For all of the above reasons the Commission should approve RUCO's recommendations.

RESPECTFULLY SUBMITTED this 30th day of April, 2015.

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